IT 97-11
Tax Type: INCOME TAX
Issue: Financial Organization(s) (General)
Replacement Tax Investment Credit/Property Used In Retailing
Reasonable Cause Asserted On Application of Penalties

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARINGS DIVISION
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	)	
	)	
v.	)	**No.**
	)	**FEIN #**
TAXPAYER CORPORATION,	)	**Tax Yrs. ending 8/31/89-94**
	)	**Charles E. McClellan**
	)	**Admin. Law Judge**
Taxpayer	)	

RECOMMENDATION FOR DISPOSITION

Sean Cullinan, Special Assistant Attorney General, for the Department of Revenue. Sidney E. Morrison and Clive D. Kamins of Morrison, Kamins & Saltz, P.C., for the Taxpayer.

Synopsis:

This matter involves two Notices of Deficiency (NOD's) issued to TAXPAYER (Taxpayer). The first NOD, dated April 30, 1993, proposed additional income tax assessments and penalties for the years ended on August 31, 1989, August 31, 1990, and August 31, 1991, in the total amount of $50,315. The second NOD, dated July 17, 1996, proposed additional income tax assessments, penalties and interest for the years ended on August 31, 1992, August 31, 1993, and August 31, 1994, in the total amount of $39,954. Taxpayer filed timely protests to both NOD's. The NOD dated July 17, 1996, was originally set for hearing as case number, but by order of the Administrative

Law Judge entered upon motion by the parties, it was consolidated with this case. Following consolidation of the two cases, taxpayer then filed a Motion for Summary Judgment (Motion) on November 18, 1994, and a supplement to its motion on November 23, 1994. The Department filed a response to taxpayer's motion and supplement and the taxpayer filed a reply brief. A hearing was held on taxpayer's motion on June 29, 1995. It was denied by order entered on August 8, 1996. The case was then set for evidentiary hearing on November 19, 1996, following which both parties filed briefs. Based on the record in this case, I recommend that the Department's assessments be made final.

Findings of Fact:

1. Taxpayer is an Illinois corporation located in Skokie, Illinois. (Dept. Ex. No. 1)

2. For the taxable years at issue, taxpayer claimed replacement tax investment credit on tangible personal property it purchased consisting principally of automobiles, but also on furniture, fixtures and computers . (Dept. Exs. No. 1, 3, 5, 7)

3. The Department disallowed the credit claimed on the grounds that taxpayer did not employ the underlying property in a qualifying use as required by Section 201(e) of the Illinois Income Tax Act. (Tr. pp. 14, 64; Dept. Exs. No. 3, 7)

4. During the years at issue and at the present time, taxpayer's primary business activity consists of the financing of used car purchases by consumers from used car dealers or the used car departments of new car dealers. (Tr. pp. 78, 103)

5. The taxpayer's vehicle financing business consists of purchasing and servicing consumer retail installment contracts that are of a quality that banks generally will not purchase. (*Id*.)

6. The vehicle financing business produced over 50% of taxpayer's gross receipts. (Tr. p. 129)

7. This type of transaction is initiated when a potential vehicle purchaser at a used car dealer or the used car department of a new car dealer wants credit to buy a vehicle and the dealer transmits his or her credit application to taxpayer for approval. (Tr. p. 128)

8. If the loan is approved, the dealer sells or assigns the customer's installment contract to the taxpayer which then receives installment payments from the vehicle buyer and services the contract. (Tr. pp. 79, 129)

9. Taxpayer also provides vehicle insurance and motor club membership to the vehicle purchaser if he or she cannot obtain it or chooses not to obtain it elsewhere. (Tr. pp. 79, 109)

10. A small portion of taxpayer's gross receipts are derived from arranging the insurance coverage and motor club membership for the vehicle purchasers. (Tr. pp. 129, 130)

11. If a vehicle purchaser defaults on his or her installment contract, taxpayer repossesses the vehicle. (Tr. pp. 80, 107)

12. Taxpayer either sells the repossessed cars to consumers, if they are driveable, or sells them for parts or junk. (Tr. pp. 80, 107)

13. Another aspect of taxpayer's business is the leasing of new cars under master leases to Bell Auto Leasing, an Illinois

corporation located in Northbrook, Illinois ("Bell"). (Tr. pp. 82, 83, 103, 104)

14. Bell is in the business of leasing vehicles to consumers in Illinois. (Tr. pp. 83, 104, 109)

15. Taxpayer purchases the new cars from new car dealers, groups them under a master lease with Bell as lessee, and finances the purchases through one of three lenders with the master lease as security. (Tr. pp. 108, 109)

16. During the terms of the master lease and sublease, title to the vehicles remains with taxpayer. (Tr. pp. 83, 110)

17. Bell acquires no ownership interest in the vehicles. (Tr. pp. 84, 111)

16. Insurance on the vehicles is issued in taxpayer's name. (*Id.*)

17. Bell cannot assign the subleases without taxpayer's agreement. (*Id.*)

18. Upon the expiration of the subleases, taxpayer may re-lease the vehicles, sell them to the lessee or place them on the car lot adjacent to taxpayer's place of business in Skokie for sale. (Tr. pp. 83, 89, 90, 110)

Conclusions of Law:

The Department's *prima facie* case was established by the admission into evidence of the Notices of Deficiency dated April 30, 1993 and July 17, 1996[1]. (Dept. Exs. No. 1, 5, 8). The record in

[1]. See 35 ILCS 5/914

this case shows that this taxpayer has failed to provide evidence sufficient to overcome the Department's *prima facie* case of Illinois income tax liability under the assessment at issue. In support of this recommendation, the following conclusions are made:

ISSUE 1

The first issue in this case is whether the Department properly denied the Personal Property Tax Replacement Income Tax investment credit that taxpayer claimed for the years at issue on the new vehicles that taxpayer purchased from car dealers for leasing to Bell and on the other property taxpayer purchased for use in its business. The statute allows a credit against the Personal Property Tax Replacement Income Tax for investment in qualified property. 35 ILCS 5/201(e). For purposes of the credit, the term "qualified property" is defined in § 201(e)(2). That section provides five conditions property must satisfy to be qualified property. The parties agree that the property at issue satisfies four of them. The dispute is whether the property satisfies the fifth condition. That condition requires that it be used in Illinois by a taxpayer in one of the activities specified in the statute. The specified activity involved in this case is retailing. Prior to January 1, 1994, the relevant statutory provision read as follows:

> (2) The term "qualified property" means property which:
>
> > (D) is used in Illinois by a taxpayer in manufacturing, or in mining coal or fluorite, or in retailing; . . .." 35 ILCS 5/201(e)(2)(D).

P. A. 88-141, § 5 amended subparagraph (D) effective January 1, 1994, by adding the phrase "who is primarily engaged" so that it now reads:

> (D) is used in Illinois by a taxpayer who is primarily engaged in manufacturing, or in mining coal or fluorite, or retailing; (*Id*.)

The term "retailing" is defined in § 201(e)(3) as follows:

> For purposes of this subsection (e), the term retailing means the sale of tangible personal property or services rendered in conjunction with the sale of tangible consumer goods or commodities. 35 ILCS 5/201(e)(3).

There are several rules of statutory construction that apply to the determination of the issues in this case. Because this case involves an issue regarding a credit against tax and a credit against tax is a privilege allowed by statute as a matter of legislative grace, it is to be strictly construed against the taxpayer. Balla v. Dept. of Revenue, 96 Ill. App.3d 293 (1st Dist. 1981) In a case involving a credit against tax, the taxpayer has the burden of proving that it is entitled to the credit and it cannot do so by testimony alone. *Id*. In addition, the words used in the statute must be given their plain and ordinary or commonly accepted meaning unless that would defeat the purpose of the statute. United Airlines, Inc., v. Mahin, (1971) 49 Ill.2d 45, 52. As noted above, the statutory provision involved in this case was amended effective January 1, 1994. Since the periods at issue straddle that date, the facts of this case must by analyzed under both versions of the statute.

Taxpayer argues that it is a "retailer" because it finances used car purchases for individuals who are buying the cars from dealers or from its own inventory of used cars. (Taxpayer Brief pp. 7, 8) It argues that this activity brings it within the definition of retailing in the statute. Taxpayer's argument goes beyond a

reasonable construction of the statute. For example, under taxpayer's theory, all of Commonwealth Edison's property purchased during the audit period would qualify for the credit because it provided a service in connection with the sale of tangible personal property when it supplied electricity to the offices of taxpayer and the used car dealers to power their lights and office equipment at the time the cars were sold. It is inconceivable that the legislature would have intended such a broad construction of the statute, and there is no legislative history pointing to such a construction.

In this case, taxpayer is not selling tangible personal property or selling services in conjunction with the sale of tangible consumer goods or commodities except when it sells its used cars from its own lot. The clear meaning of the statutory language as it read prior to the amendment is that to be qualified the property must by used by a person who is a seller of tangible personal property and the property in question must be used by that person in making such sales or be used by that person in selling service as an adjunct to the sale of tangible personal property .

For periods after the amendment, the statute requires that the taxpayer's primary business must be selling tangible personal property or selling services as an adjunct to such sales. Taxpayer's primary business is the financing of the purchase of used vehicles being sold to consumers by used car dealers or by the used car departments of new car dealers. When taxpayer finances a car being purchased by a consumer from a used car dealer or the used car department of a new car dealer, it sells nothing at retail, so it is

not a retailer in that type of transaction. Taxpayer's accountant, Mr. XXXXX testified that more than 50% of taxpayer's gross receipts are derived from financing used car sales. (Tr. p. 129) Therefore, taxpayer does not qualify as a retailer under the language of the statute, either pre or post amendment.

Next, taxpayer argues that it is entitled to the credit as a matter of law, apparently because under the taxpayer's reading of the statute and regulation the Department "has been and now is in doubt as to the application of the tax investment credit." (Taxpayer Brief p. 10) Taxpayer points out in its brief, that taxing statutes are to be strictly construed and not extended beyond the clear import of the language used, and, in case of any doubts, the statute is to be construed most strongly against the government and in favor of the taxpayer. (*Id.*) As noted above, however, a companion rule of statutory construction is that because this case involves an issue regarding a credit against tax and a credit against tax is a privilege allowed by statute as a matter of legislative grace, it is to be strictly construed against the taxpayer. Balla, *supra*. Taxpayer also cites the rule that administrative regulations and rulings can neither limit, enlarge nor amend the scope of the statute beyond the clear import of the language used. There is, however, no doubt or ambiguity in how to apply the statute or the regulation to the facts of this case under either the pre-amendment language or the post-amendment version.

As pointed out in the Department's brief the Department interprets the pre 1994 language to mean that eligible items are required to be used exclusively in retailing. After the 1994

amendment to the statute, the Department eliminated the exclusivity requirement. (Dept. Brief p. 6) As to the periods prior to January 1, 1994, as stated above, there is no evidence in the record to show that the taxpayers used any property at issue in this case in making sales of tangible personal property or in making sales of services rendered in conjunction with the sale of tangible consumer goods or commodities as required by the statute. As to the periods after December 31, 1993, the testimony of taxpayer's own witness proved that it was not a retailer or primarily engaged in retailing within the meaning of the statute or under the applicable regulation.

Taxpayer's arguments that the vehicles qualify for the credit are without merit. To qualify for the credit during the periods at issue that are prior to January 1, 1994, the taxpayer's vehicles and other property for which the credit was claimed must have been used in "retailing" as defined in the statute. Insofar as it applies to this case, the statute defined "retailing" as the sale of tangible personal property or the sale of services rendered in conjunction with the sale of tangible consumer goods. The word "conjunction" is not defined in the statute. However, a dictionary definition of "conjunction" is: "1. The act of uniting or the state of being united. 2. A simultaneous occurrence in space or time; concurrence." Webster's II New College Dictionary (1995 ed.) p. 238. Thus, for property to qualify for the credit, the statute required that it be used by the taxpayer either in the sale of tangible personal property or in the sale of service rendered at the time and place of such a sale. The statute did not provide for qualification of property that belonged to someone other than a person making a

retail sale, nor did it allow the credit to be taken on a retailer's inventory, *i.e.*, property being held by a retailer for sale in the ordinary course of business.

With regard to the cars at issue in this case, when taxpayer bought new vehicles from dealers, it was not investing in them to use in conjunction with the sale of tangible personal property. It was investing in them for use in its leasing business. When it leased the vehicles to Bell, there was no sale, so it was not using them in making a retail sale or in making a sale of service in conjunction with making a retail sale. To qualify for the credit, property had to be used in making a retail sale of property or in making a sale of services rendered in conjunction with the sale of tangible consumer goods or commodities as, for example, a cash register is used in a supermarket checkout line.

Taxpayer's vice president and controller testified that taxpayer is in the business of financing the purchase of used cars. (Tr. p. 78) Taxpayer's independent certified public accountant testified to the same effect. (Tr. p. 103) Thus, the testimony of its own witnesses showed that taxpayer is not engaged in retailing except when it sells repossessed cars and cars that are returned after their leases from Bell expire. When cars are repossessed by or returned to the taxpayer after their leases expire, the cars are held out for sale. In that situation the vehicles are not used in retailing within the meaning of the statute, they are the subject of the sales, *i.e.*, they are the tangible personal property being sold.

Referring in it's brief to the disallowance of the credit for its automobiles, taxpayer seems to find error in the fact that the

Department's auditor testified that he disallowed the credit on the automobiles because he thought that Bell's customers, rather than the taxpayer, were the users of the cars within the meaning of the statute. (Taxpayer Brief p. 3, 4) Taxpayer points out that the Illinois Income Tax Act does not define the term "use" or "used by". (Taxpayer Brief p. 5) Taxpayer then cites Telco Leasing, Inc. v. Allphin, 63 Ill.2d 305 (1976) Continental Illinois Leasing Corporation v. Dept. of Revenue, 108 Ill. App.3d 583 (1st Dist. 1982) and Square D Company v. Johnson, 233 Ill. App.3d 1070 (1st Dist. 1992) which held that the owner-lessor of property is the user under the Illinois Use Tax Act. (Taxpayer Brief p. 6)

Taxpayer's argument seems to imply that if taxpayer is using the vehicles no one else can use them at the same time. Taxpayer's vice president and controller, Ms. XXXXX, testified quite accurately, but somewhat incompletely, about the use of the vehicles at issue. When asked the question of who uses the automobiles during the term of the Bell leases, she testified, "We use it for business purposes to make money, and the customer is using it under their lease." (Tr. p. 88) Further on she testified, "I feel we're using it from [*sic*] the company. We're using the vehicle to make money. It's the business. We're leasing, right?" (Tr. p. 89) The only thing she left out of her testimony was the fact that Bell is also using the vehicles to make money under the terms of its customer leases. Thus, these vehicles are used simultaneously by three parties for two different purposes. First, taxpayer and Bell are using them to make money under their leases. Second, Bell's customers are using them to provide transportation.

In any case, for the periods prior to January 1, 1994, the issue is whether taxpayer used them in retailing within the meaning of the statute. The record shows that the taxpayer did not use them in that way. It used them in its leasing business which is not retailing because there is no sale of tangible personal property or commodity involved in the transactions between taxpayer, Bell and Bell's customers.

With respect to the property other than cars for which the Department disallowed the credit, taxpayer did not refer to it specifically in its brief, nor did it introduce any evidence at the hearing explaining how it is used in retailing. When the taxpayer sells used cars, it is engaged in retailing. However, the record does not show if, when or how any property at issue was used in that part of taxpayer's business. It has not introduced any evidence to indicate that any of its property qualifies as property used in retailing within the meaning of the statute.

The statute was amended effective on January 1, 1994, to provide that the property must be used by a taxpayer who is primarily engaged in manufacturing, or in mining coal of fluorite or in retailing. The regulations require that to be primarily engaged in one of the qualifying activities, more than 50% of taxpayer's gross receipts must be derived from that activity. 86 Admin. Code ch. I, § 100.2101(f) As noted above, taxpayer's accountant, Mr. XXXXX testified that more than 50% of taxpayer's gross receipts are derived from financing used car sales. (Tr. p. 129) The record clearly shows that taxpayer is not primarily engaged in retailing as required by the statute.

Therefore, for the reasons stated above, the Department's disallowance of the credit claimed as set forth in the NOD's must stand.

ISSUE 2

The second and last issue in this case is whether the Department's proposed assessment of penalties under § 1005 of the statute[2] should stand. Section 3-8 of the Uniform Penalty and Interest Act provides that the penalty shall not apply if the taxpayer's failure to pay is due to reasonable cause. 35 ILCS 735/3-8. The statute does not define the term "reasonable cause". The regulations provide that reasonable cause is to be determined on a case by case basis taking into account all pertinent facts and circumstances. 86 Admin. Code ch., I, § 700.400 at ¶ (b) The most important factor is whether the taxpayer made a good faith effort to comply with the law and if he exercised ordinary business care and prudence in doing so. *Id*. at ¶ (c).

In the instant case the taxpayer did retain a certified public accountant to prepare its Illinois income tax returns. However, that fact alone does not demonstrate the exercise of ordinary business care and prudence. There is no evidence in the record to indicate what, if any, analysis was done at the time the decision was made to claim the credit on the question of whether the property at issue qualified for the credit. Taxpayer's independent certified public accountant, Mr. XXXXX, testified as to his familiarity with the sections of the statute providing for the credit involved in this case. (Tr. pp. 114-120) He also testified that he was familiar

[2]. 35 ILCS § 5/1005

with Private Letter Ruling 88-141 issued by the Department on May 12, 1988, but he was not sure when he became familiar with it. (Tr. p. 125)

Private Letter Ruling 88-141 involved a taxpayer that rented and sold construction equipment. The issue was whether the rented equipment qualified for the same credit that is involved in this case. The Department ruled that it did not qualify because the taxpayer was not using the property in retailing. Although the taxpayer alluded to this ruling in its brief (at page 8) and Mr. XXXXX said he was familiar with it, there is nothing in the record to indicate whether any thought was given to this ruling letter, legislative history or any other authority at the time the taxpayer decided to claim the credit on the property at issue.

While private letter rulings are not precedent, they may reflect the policy of the Department which the Department is required to adopt. Union Electric Co. v. Department of Revenue, 136 Ill.2d 385 (1990). If Mr. XXXXX was familiar with Private Letter Ruling 88-141 and chose to ignore it, that fact alone would have indicated a disregard of the Department's policy on the issue and a lack of reasonable cause. However the record is unclear as to when he learned of it and there is no evidence in the record of anything showing the exercise of ordinary business care and prudence.

Taxpayer's arguments in this case that the property at issue is used in retailing and that taxpayer is engaged in retailing are hyperbolic at best. Therefore, because there has been no showing of the exercise of ordinary business care and prudence, the proposed penalty assessment should stand.

WHEREFORE, for the reasons stated above, the Department's proposed assessments under the Notices of Deficiency issued to TAXPAYER on April 30, 1993, and on July 17, 1996, should be made final.

Date

Charles E. McClellan
Administrative Law Judge